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No. 79-1266

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

CHARLES W. STEADMAN,
Petitioner

v.

SECURITIES AND EXCHANGE COMMISSION,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE NATIONAL COMMITTEE OF DISCOUNT SECURITIES BROKERS AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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INTEREST OF THE NATONAL COMMITTEE OF DISCOUNT SECURITIES BROKERS

The National Committee of Discount Securities Brokers ("Committee") is an *ad hoc* group of securities brokers who are registered as broker-dealers with the Securities and Exchange Commission ("Commission") pursuant to Section 15 of the Securities Exchange Act of 1934. 15 USC §78o. As such, the members of the Committee are subject to the antifraud provisions of the federal securities laws as well as the disciplinary authority of the Commission under Section 15(b) of the 1934 Act. 15 USC §78o(b). Section 15(b) disciplinary authority is exactly

parallel to the Commission's disciplinary authority over investment advisers under Section 203(f) of the Investment Adviser's Act of 1940, 15 USC §80b-3(f), that is at issue in the case at bar. Accordingly, the members of the Committee have a substantial and immediate interest in the question now before the Court of whether in an administrative proceeding before the Commission, violations of the antifraud provisions of the federal securities laws must be proved by clear and convincing evidence, rather than by a preponderance of the evidence. For this reason the Committee wishes to file a brief *amicus curiae* in support of the position of petitioner, Charles W. Steadman.[1]

As *amicus curiae,* we are concerned with the broad policy implications of this case. It glaringly presents the abuse of discretion and warping of authority by which the Commission over the years has lifted itself by its own bootstraps from exercising the limited regulatory powers granted to it by Congress to an omniscient exerciser of what can only be called the equivalent of Article III judicial powers. The Committee urges the Court in deciding this case to hold that because of common law principles, the Fifth Amendment and the statutory considerations discussed hereinbelow, that the Commission must apply the clear and convincing standard of proof in administrative proceedings as to *each element* of the alleged violations under all three subsections of Section 17(a) of the 1933 Act, and as well under Subsections (1) and (2) of Section 206 of the Advisers Act.

The policy justification for such a holding lies primarily in the nature of the securities industry, the overlapping, in-

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[1]Counsel for the Committee, Carl L. Shipley, is also general counsel of Steadman Security Corporation and the five mutual funds managed by Steadman Security Corporation. Mr. Steadman, petitioner herein, is the chairman and president of each of these entities.

terlocking, obscure and tangled provisions of the federal securities laws, and the Houdini-like escape of the Commission from the bounds of authority which Congress thought it had enacted in the 1933 and 1940 Acts. Such unrestrained exercise of power by the Commission brings to mind principles first enunciated by Thomas Jefferson when he wrote:

> "In questions of power, then, let no more be heard of confidence in man, but bind him down from mischief by the chains of the Constitution."[2]

In light of the "tangled web" of the securities laws and the regulations thereunder and the sometimes over-zealous way in which they are enforced by the Commission, the Committee submits that the imposition of the clear and convincing standard is a proper and necessary means to protect the constitutional rights of the citizen from the "stealthy encroachments" feared by Justice Bradley in ***Boyd v. United States,*** 116 U.S. 616, 635. The Committee believes that this burden must be imposed for the reasons stated by this Court in *Jones v. Securities and Exchange Commission,* 298 U.S. 1 (1935):

> "The philosophy that constitutional limitations and legal restraints upon official action may be brushed aside upon the plea that good, perchance, may follow, finds no countenance in the American system of government." (*Id.* at 27.)

While the case at bar deals with one man and one set of circumstances, the Committee believes that it is important to bring to the Court's attention the inequities involved therein because they affect every member of the Commit-

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[2]P.L. Ford, "The Writings of Thomas Jefferson", Volume VII, 1795-1801, G.P. Putnam's Sons, New York, 1896, page 306.

tee who must work in the environment regulated by the Commission.

The outcome of this case affects not only the members of the Committee who are but a few of the 6,246 brokers and dealers registered with the Commission, some of whom are among the 5,664 investment advisers similarly registered, but it will affect many others. For example, there are 1,552 publicly owned companies whose shares are traded on the New York Stock Exchange, 964 on the American Stock Exchange, and 197 on the other stock exchanges, as well as 30,000 whose shares are traded in the over-the-counter market. All of these companies, and all other companies with assets in excess of $1 million and 500 or more public shareholders, are required to file annual reports with the Commission, send reports to their shareholders, and provide investors with prospectuses whenever they issue and distribute securities to the investing public. In addition, these companies send proxy statements to their shareholders each year. All of these documents are required to be filed with the Commission and are subject to the antifraud provisions of the federal securities laws.

Although the Commission proceeding involving Steadman was brought under Section 9(b) of the Investment Company Act of 1940 (15 USC §80a-9(b)), and Section 203(f) of the Investment Advisors Act of 1940 (15 USC §80b-3(f)), the Commission has similar broad discretionary enforcement powers under all of the securities acts. The impact of this decision respecting the requisite degree of proof will provide guidance to the entire securities industry.

SUMMARY OF ARGUMENT

The Securities and Exchange Commission has entered an order that imposes an economic death sentence on Petitioner. This drastic sanction was inflicted on the basis of a mere preponderance of the evidence. Because of the drastic nature of the sanction and because it is based upon allegations of fraud, the Commission should be required to prove its findings by clear and convincing evidence. There is ample precedent for the imposition of this higher standard of proof.

In light of the tangled web of federal securities laws and regulations that often are not susceptible to common understanding and the sometimes over-zealous manner in which the Commission enforces these laws and regulations, the clear and convincing standard of proof should be required with respect to every element involved in the particular offense alleged.

The facts of this case illustrate that the clear and convincing standard is necessary to prevent the Commission from reaching inequitable and unjust results by straining and torturing the common sense meaning of statutory language. This standard of proof is also necessary to prevent unjust and inequitable results occasioned by the Commission's reliance on Sections 17(a)(2) and (3) instead of Section 17(a)(1) of the Securities Act of 1933 thereby avoiding proof of scienter or any awareness of wrongdoing.

ARGUMENT

THE CLEAR AND CONVINCING STANDARD OF PROOF SHOULD BE IMPOSED ON THE COMMISSION WITH RESPECT TO EVERY ELEMENT INVOLVED IN THE OFFENSE ALLEGED

The Securities and Exchange Commission has imposed on Charles Steadman the economic death sentence of permanent debarment from the investment company advisory industry.[3] The Commission has done so on the basis of findings supported merely by a preponderance of the evidence. Specifically, it found (1) that the four mutual funds for which Steadman Security Corporation ("SSC") acts as investment adviser did not disclose in their prospectuses that both Steadman and SSC had loans from the Chase Manhattan Bank in New York, the custodian of the assets of the mutual funds; (2) that the potential for abuse by virtue of Steadman's influence over where the mutual funds did their banking was sufficiently great that, in the Commission's opinion, shareholders would want to know about such loans; (3) that this collateral banking relationship was material information that the mutual funds had a duty to reveal; (4) that the funds' failure to disclose this information was caused by and aided and abetted by Steadman; and (5) that this failure to disclose was a violation of Section 17(a) of the Securities Act of 1933 (15 USC §77q(a)) and Sections 206(1) and (2) of the Investment Advisers Act of 1940 (15 USC §80b-6).[4]

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[3]The Committee is directly interested in the Commission's power to impose such drastic sanctions under the Investment Advisers Act of 1940 because its members are subject to this same power under Section 15(b) of the Securities Exchange Act of 1934. 15 USC §78o(b).

[4]On appeal the United States Court of Appeals for the Fifth Circuit granted in part and denied in part Steadman's petition for review, set aside the Commission's order and remanded the cause for reconsidera-

The question presented to the Court contains several lesser included questions which are ripe for review and important to a resolution of the problems existing in the securities industry because of uncertainty as to the Commission's administrative burden of proof in enforcing the antifraud provisions of the federal securities laws.

One of these important lesser included questions involves whether the clear and convincing standard should be imposed on the Commission with respect to every element involved in the offenses alleged. In this case the Commission built its case not on employment of any "device, scheme or artifice to defraud" under Section 17(a)(1), not on "engaging in any transaction, practice, or course of business which operates or could operate as a fraud or deceit" under Section 17(a)(3), not on obtaining "money or property by means of any untrue statement of a material fact" under clause one of Section 17(a)(2), but on the very nebulous accusation under clause two of 17(a)(2) that Steadman personally caused and aided and abetted an "omission to state a *material fact* necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading" (emphasis added) in the mutual funds' prospectuses.

The "material" fact at issue is Steadman's collateral banking relationship. Importantly however, this Court

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tion consistent with its opinion. The Fifth Circuit held, however, that the Commission properly applied a preponderance of the evidence standard of proof. This is directly contrary to *Collins Securities Corp. v. Securities and Exchange Commission,* 562 F2d 820 (D.C.Cir.1977) and *Whitney v. Securities and Exchange Commission,* 604 F2d 676 (D.C.Cir.1979), both of which hold that no permanent or substantial debarment from the securities industry may be imposed in an administrative proceeding by the Commission, regardless of the circumstances, unless the alleged violations are proven by clear and convincing evidence.

may judicially notice that neither Congress by statute nor the Commission by regulation has ever afforded Steadman, similarly situated persons or anyone else in the industry, any notice[5] that the mere existence of a collateral banking relationship between an officer or director of a public corporation and a commercial bank with which the corporation does business, in the absence of any conflict, is nonetheless a material fact required to be disclosed at the peril of being debarred from the securities industry for fraud.

When neither Congress by statute nor the Commission by rule has put officers and directors on notice that such collateral banking relationships constitute "material" information within the meaning of clause 2 of Section 17(a)(2) and amount to "engaging in a transaction, practice, or course of business which operates as a fraud" within the meaning of Section 206(2) of the 1940 Advisers Act, fairness requires that the question of materiality be determined on the basis of clear and convincing evidence.[6] The Commission can trigger its power to debar, as it did in this case, merely by finding a material omission. In order

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[5]In contrast, Congress provided specifically in Schedule A of the Securities Act of 1933, 32 items of material information to be included in a prospectus. 15 USC §77. Furthermore, a prospectus must contain "such other information as the Commission may by rules or regulations require as being necessary or appropriate in the public interest or for the protection of investors." 15 USC §77j. This regulatory scheme properly provides notice of those matters which the Commission and the Congress consider important to the investing public.

[6]"The issue of materiality may be characterized as a mixed question of law and fact, involving as it does the application of a legal standard to a particular set of facts. . . . The determination requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him, and these assessments are peculiarly ones for the trier of fact." *TCS Industries, Inc. v. Northway, Inc.*, 426 U.S. 406, 450 (1976).

properly to safeguard against abuse of this power, the Commission shold be required to prove that an omission was material by clear and convincing evidence.

With respect to the allegedly "material fact" at issue here, close analysis reveals that it was not material at all. The Commission made no finding that Steadman's self-interest in currying the good favor of the bank induced him to keep large amounts of the funds' cash in non-interest bearing checking accounts. On the contrary, the Division of Enforcement never even alleged that checking account balances were ever excessive and the Commission specifically refused to make such a finding. *Steadman v. Securities and Exchange Commission*, 603 F2d 1126, 1130 (5th Cir.1979). The Commission's findings were merely based on the *theory* that the loans had created the *potential* for maintaining excessive account balances.[7] *Id.* Had the Commission been required to prove by clear and convincing evidence that failure to disclose the collateral banking relationships was a "material omission", a different result would have ensued.[8]

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[7]The truth of the matter is that the record establishes that the mutual funds benefitted by more than an $800,000 savings in custodian fees as a result of transferring the funds' accounts to banks with which Steadman happened to have collateral relationship.

[8]The Commission's "theory" and "speculation" as to the effect of the collateral banking relationship finds absolutely no support even as a practical matter. This Court may judicially notice that all major corporations keep substantial amounts of cash in non-interest bearing accounts for a variety of reasons. One such common reason is to obtain more favorable interest rates on loans taken down by the corporation involved. Certainly the officers and directors of these corporations have loans outstanding from the banks involved. Yet the Commission cannot conceivably assert that these loans should be disclosed. It is simply common business practice. Disclosure of this nature would, for a large corporation, encompass pages and pages and impose an outrageous and unmerciful burden.

A second lesser included question is whether the Commission must prove by clear and convincing evidence that *Steadman* caused or aided and abetted the *mutual funds* in filing and disseminating prospectuses which omitted the information concerning the collateral banking relationships. Steadman did not file or disseminate prospectuses, the mutual funds did. Section 6(a) of the 1933 Act (15 USC §77f) requires the issuer to file a registration statement — not Steadman. The corporate funds were the "issuers". Steadman was but one member of the board each of whom signed the registration statement and shared responsibility for disclosure. Section 10(a) of the 1933 Act makes *every person* who signs liable, but Section 11(c) is a safe-harbor for signers who exercise prudent and reasonable care as to the prospectuses' disclosure. The funds acted through their boards of directors and officers, who relied on information furnished by legal and accounting professionals. The Court may judicially notice that prospectuses relating to securities are highly technical documents, prepared by experienced lawyers, independent public accounts and employees of the *issuer,* not any particular officer or director.[9]

If there was a material omission in the prospectus, the responsibility must be placed with the corporate mutual funds, not with Steadman or any other individual officer or director absent specific proof to the contrary by clear and convincing evidence.

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[9]The Securities Act of 1933, which requires an effective registration statement containing a prospectus as a condition precedent to the distribution of securities, provides in pertinent part: "Any securities may be registered with the Commission . . . by filing a registration statement in triplicate, at least one of which shall be signed by each *issuer,* its principal executive officer . . . its principal financial officer, its comptroller . . . and the majority of its board of directors." (15 USC §77f) (Emphasis added.)

The members of the boards of directors of the mutual funds at the time of the alleged violations (1968) were men of outstanding reputation and business experience.[10] Most served on the boards of many corporations. They had decades of experience as corporate directors. It is not reasonable that these men, experienced as they were in the responsibilities of serving as corporate directors, would stand by idly and allow Steadman to cause the corporations which they served to omit material information from prospectuses prepared by legal and accounting counsel in behalf of such corporations. It is sheer speculation to assume that Steadman, as one individual, usurped the business judgment of such men as to disclosure or anything else.

Respondents argued below that Steadman had a "duty" to disclose his collateral banking relationship. However, the SEC can point to no such statutory or regulatory duty. How can there be a duty to disclose a commonplace practice in the business world – a non-conflicting collateral banking relationship – when neither Congress nor the SEC have enumerated it among the forseeable material

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[10]The directors and some of their affiliations are set forth below:

Edward R. Farley, Jr. – Chairman and President of the Atlas Corp. (mining and manufacturing); Trustee, Lincoln Savings Bank (Brooklyn); **Robert W. Fleming** – Investment Banker; Executive Vice-President and Director, Folger Nolan Fleming Douglas, Inc. (members NYSE); Director, Interstate Federal Building Association; Director, Acacia Mutual Life Insurance Co.; Director, Security Storage Co.; **Frederick M. Glass** – Vice-Chairman of the Board, Empire State Bldg. Corp.; Executive-Vice President and Director, Hertz Corp.; President and Director, National Car Rental System, Inc.; Chairman, Cosmos American Corp.; Director and Vice-Chairman, Cosmos Bank (Zurich); President and Director, Cosmos Equity Corp.; President and Director, Prudential Group, Inc.; **Joseph P. Kazickas** – President and Director, Neris Carbon & Oil Corp.; Director, Cosmos Bank (Zurich); **Harry C. Mills** – Retired; formerly Vice-President and Director, J.C. Penney Co.

disclosure items (Schedule A, 1933 Act, SEC Form N-1, 17 CFR 239.15)?

There are probably 50,000 publicly owned corporations in the U.S. If each has an average of 10 directors, that suggests a half million directors. These are matters of common knowledge. Most commercial banks require compensating non-interest bearing balances as a condition of commercial loans. This is a particularly prevalent fact of business life for securities brokers. In addition, corporations have trust, mortgage, pension plan, and other banking relationships. The business reality is that businessmen who are engaged in substantial activities would find it virtually impossible not to have a collateral relationship with some bank with which corporations also have a relationship. Fraud should depend on actual, not potential conflicts. The SEC should not be permitted to back into a fraud charge (Section 17(a)(2) "omission") by elevating a non-material bit of information to the level of materiality, and then perceiving its disclosure as a "duty" for a non-issuer under Section 6(a), without meeting at least a clear and convincing standard. And can a "potential" risk of abuse of a power to maintain excessive cash in non-interest bearing accounts on the part of one person who, as one officer and director of a corporation with many officers and directors, ever be "material" for SEC disclosure purposes? We submit such a theory is so unlikely it must be supported by clear and convincing evidence when debarment is the penalty for non-disclosure. Without a "duty" to disclose the relationship, there can be no liability. Because this is an essential element of the alleged offsense, the Committee submits that it too must be proved by clear and convincing evidence. Under the facts of the case, however, the Commission could not possibly have proven a duty to disclose by any standard of proof much less by clear and convincing evidence. Whether one has a duty to disclose what might

later be labeled a material omission depends upon the individual's state of mind at the time, i.e., whether he had any specific intent or "awareness of wrongdoing." See *Investors Research Corp. v. Securities and Exchange Commission,* No. 78-1597 (D.C. Cir., decided April 29, 1980). The Commission's own findings establish that Steadman had no "awareness of wrongdoing" at the time. If the potential for abuse existed, no such abuse was alleged or proved.[11] Wrongdoing requires a wrongful intent implemented by a wrongful act. Every corporate officer and director is capable of a myriad of "potential" wrongs – misappropriation, embezzlement, larceny, forgery – but the SEC has never required anyone else to catalog in a prospectus all of the potential risks of conflict. Why Steadman?

Had the Commission been required to prove by clear and convincing evidence that a duty to disclose existed, what the Committee believes to be an unjust and inequitable result would not have ensued.

The Commission also found that Steadman had aided and abetted a violation of Section 15(a)(1) of the Investment Company Act (15 USC §80a-15(a)(1)) which prohibits an adviser from receiving "compensation" not "precisely" described in the advisory contract between the advisory company and the mutual fund. SSC's contract with two of the mutual funds limited its annual advisory fee to 1% of average net assets. The fee was payable monthly based on estimates of average net assets. Because

[11]The Commission made no finding that Steadman's self-interest in currying the good favor of the banks induced him to keep large amounts of the funds' cash in non-interest bearing accounts. On the contrary, the Division of Enforcement never alleged that checking account balances were excessive and the Commission specifically refused to make such a finding. *Steadman v. SEC,* 603 F2d 1126, 1130 (5th Cir.1979).

assets declined sharply near the end of the fiscal year, accounting revealed that SSC owed the two funds $260,000 in refundable fees. This was simply an account payable by Steadman Security Corporation and an account receivable to the mutual fund. The directors in an exercise of prudent good faith business judgment fixed 6% interest on the account receivable and approved a repayment arrangement. Thus, it was like unrealized appreciation and other accounts receivable, reflected in the fund's daily net asset value. (17 CFR 270.2a-4; SEC Rule SX, Art. 6, 6-03). An account receivable in accordance with usual accounting practice and SEC rules cannot be "compensation" because the SEC staff develops some self-serving theory contrary to the facts and law. Surely the barrier of clear and convincing evidence should be erected to protect the industry from such semantic contortions.

The Commission found that Steadman's failure to disclose the repayment arrangement was a violation of the antifraud provisions. In so doing it contorts the board's good faith business judgment into a failure to disclose "compensation" by Steadman (when SSC, not Steadman, was the advisor) in order to "get" Steadman under Section 15, a gross abuse of administrative power.

Because the aiding and abetting findings were bootstrapped by the Commission into antifraud violations which resulted at least in part in the debarment order, the Committee believes that the aiding and abetting violations must be supported by clear and convincing evidence. That this evidentiary safeguard is needed to protect against the Commission abuses discussed above is made clear by the fact that the Commission did not even find that the allegedly omitted fact was a material one. *Steadman v. SEC, supra* at 1135. The District of Columbia Circuit has

recently restated the requirement that an aiding and abetting charge by the SEC must be supported by proven awareness of wrongdoing. *Investors Research Corp. v. SEC,* No. 78-1597 (D.C. Cir., April 29, 1980). This Court should establish, in addition, the clear and convincing standard for aiding and abetting.

Without such protection, the Commission has a free rein to do precisely what it did in this case – strain and torture the common sense meaning of "compensation" to achieve its own purposes. All that was involved here was a fee overrun that was contemplated by the advisory agreement. The agreement was silent, however, as to the method or timing of such repayments. No law or rule says that such overruns must be repaid at the time they are accounted for.

There was no impropriety here, no dishonesty, no wrongdoing. For financial accounting purposes the overrun was treated like an account receivable and was in the nature of unrealized appreciation, with one difference – SSC was paying the funds 6% interest on the obligation.[12] In this regard it is important to note that unrealized appreciation, other accounts receivable and many common stock dividends in the portfolio yield less than 6%.

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[12]The 6% interest was higher than 5% passbook savings rates and was compatible with commercial loan interest rates at the time. Moreover, the decision as to interest rate, time of repayment, and other details are the kinds of internal management decisions confided by state law to the directors, who in this case approved the arrangement. *Cort v. Ash,* 422 U.S. 66 (1974); Sec. 141, Del. Corp. Law (the Steadman funds were Delaware corporations).

The Commission attempts to hold Steadman personally liable for a business judgment made by the boards of directors in an exercise of their good faith business judgment in accordance with state law. E.g., Del. Gen. Corp. Law §141. This fact alone should have precluded the imposition of liability on Steadman in light of this Court's holdings in *Cort v. Ash,* 422 U.S. 66 (1974) and *Sante Fe Industries v. Green,* 430 U.S. 462 (1976).

The Commission also found that Steadman and Republic Securities Corporation, a wholly-owned broker-dealer subsidiary of SSC, had aided and abetted violations of Section 17(e) of the Investment Company Act (15 USC §80a-17(e)) by receiving tender solicitation fees in connection with the tender of shares held by the funds and not remitting the fees to the funds. Here again the Committee submits that this is a lesser included question which, as well, must be proven by clear and convincing evidence because it is part and parcel of the findings which ultimately resulted in the imposition of the bar.

Section 17(e)(1) precludes an investment company, acting as agent, from receiving compensation for the purchase or sale of property to or for such company "except in the course of such person's business as an underwriter or broker." The record in this case plainly establishes that RSC in connection with the tender solicitation "did the same things that an unaffiliated broker would have had to do had the task been assigned to it." *Steadman Securities Corp.,* CCH Fed. Sec. L. Rep. ¶ 10, 107, Dec. 20, 1974, p. 13,084. RSC provided a forwarding service, a transaction service or part of a transaction service for which it was entitled to share in the fee.[13]

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[13]The transaction seized upon by the Commission was typical in the industry. It is termed a "give-up" under the rules of the New York Stock Exchange and it involves nothing more than a correspondent

Had the Commission been required to prove by clear and convincing evidence that RSC aided and abetted violations of Section 17(e) the Committee believes that the Commission could not have sustained its burden of proof.

By straining the common sense meaning of statutory language and avoiding proof of scienter, and relying on subsections (a)(2) and (a)(3) instead of (a)(1) of Section 17 of the 1933 Act, the Commission can proceed practically unrestrained to the entry of debarment orders. The Com-

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relationship where more than one broker is involved in the transaction. It is merely a method by which fees are divided –

> "A broker who surrenders a portion of his commission to another is said to "give up" the surrendered portion. "Give-ups" are of two kinds. One kind, the traditional correspondent relationship, involves a division of compensation where there has been an actual division of labor among two or more brokers in the handling of a particular transaction. Thus, if a broker who has secured a customer through personal contact, investment advice, or by providing custodial or other services, receives an order from that customer which he is unable to execute because he has no executing and clearance facilities of his own, he can forward the order to a second broker for execution and clearance. The second broker may execute the order himself. However, he may be too busy on the exchange floor with other orders, and in these circumstances he will delegate the actual execution to a floor broker who spends all of his working time on the floor and who specializes in executing orders for other brokers but does not maintain office facilities necessary to clear them. The commission may be divided among the broker who obtained the order, the second broker who arranged for the delivery of the securities from the seller's broker and handled much of the paperwork, and the floor broker who made the actual purchase on the exchange floor. Give-ups resulting from traditional correspondent relationships have not posed basic regulatory problems."
>
> (Report of the SEC on the PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, 89th Congress, 2d Sess., H.R. No. 2337)

mittee believes that the imposition of the clear and convincing evidentiary standard is necessary to protect against the nearly unbridled with which the Commission is able to impose the most serious sanction at its disposal, often with seemingly reckless abandon for the dire consequences such a penalty has on its target.

The Committee urges the Court to reject the Fifth Circuit's holding that in SEC disciplinary proceedings violations of the antifraud provisions of the federal securities laws can be proved by a mere preponderance of the evidence instead of by clear and convincing proof. The Committee submits that the proper approach to this issue has been taken by the District of Columbia Circuit in *Collins Securities Corp. v. SEC,* 562 F2d 820 (D.C.Cir.1977) and *Whitney v. SEC,* 604 F2d 676 (D.C.Cir.1979).

The D.C. Circuit's requirement of clear and convincing proof has ample support in precedent. This Court has recently held that the clear and convincing standard of proof is required in civil commitment proceedings. *Addington v. Texas,* 441 U.S. 423 (1979). The Court's rationale in requiring the higher degree of proof in *Addington* – the possibility of deprivation of liberty and the creation of a stigma – is equally applicable to the case at bar where Steadman faces exclusion from his chosen profession as well as the stigma inherent in fraud accusations.

The consequences for Steadman of debarment from the investment advisory industry is not much different in effect than if he had been sent to jail. In jail he would be locked in – in this case he is locked out; not only locked out of the investment advisory business, but locked out for "fraud", with all of its opprobrious and sinister implications of dishonesty in a case where no dishonesty is alleged. As a practical matter, he is locked out of even being an officer or director of any publicly owned corporation, and

he may even be disbarred as a lawyer and locked out of that calling.[14] A securities fraud finding locks the target respondent out of almost every significant area of business life, as well as seriously damaging personal reputation.

The realities of business life are such that Steadman will be wiped out as a result of the Commission's action in this case. On the broader spectrum the same thing happens to every other person who is subjected to the heavy artillery the Commission can bring to bear in making fraud allegations, finding fraud on the basis of a mere preponderance of the evidence, and then blowing the respondent away with permanent debarment.

Because allegations of fraud have such drastic and dire consequences, other courts have traditionally imposed the clear and convincing standard of proof. See *Woodby v. Immigration Service,* 385 U.S. 276, 285 (1966); *United States v. American Bell Telephone Co.,* 167 U.S. 224 (1897); *Maxwell Land-Grant Case,* 121 U.S. 325 (1887).

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[14]Steadman has been a member of the bar for 41 years, since he was graduated from the Harvard Law School. His reputation for trustworthiness and responsibility in the business world stand to be wiped out. Mr. Steadman has a long and distinguished career as a lawyer, a corporate executive, and the author of legal and economic articles. He has served, *inter alia,* as Chief of the Legal Division of the War Department's Cleveland Ordnance District with the rank of Lieutenant Colonel, Chief Counsel for the Senate Select Committee for Contribution Investigation (84th Congress), and Chairman of the Board of Directors of the Endowment Fund for Distinguished Teaching of the University of Nebraska. He has been a member of the Board of St. Vincent Charity Hospital and Chairman of the Cotillion Society of Cleveland. He received the University of Nebraska Distinguished Service Award in 1960. He has been actively involved in the American Bar Association, chairing various committees and serving on others, and he has authored several legal articles. This heretofore unblemished career stands to be smeared on the basis of a mere preponderance of the evidence. (See *Who's Who in America,* 1979 p. 3098)

The application of the clear and convincing standard also finds direct support in cases imposing disciplinary sanctions on attorneys because the result is the same – exclusion from one's profession. See *In re Fisher,* 179 F2d 361 (7th Cir.), *cert. denied,* 340 U.S. 825 (1950); *In re Ryder,* 263 F.Supp. 360 (E.D.Va.), *aff'd,* 381 F2d 713 (4th Cir.1976); *Charlton v. Federal Trade Commission,* 543 F2d 903 (D.C.Cir.1976).

In light of this precedent and in view of the serious consequences that befall anyone who is debarred from the securities industry on grounds of fraud, the Committee submits that the Commission should not be allowed to inflict such grevious harm on the basis of a preponderance of the evidence.

CONCLUSION

Apart from the above considerations, the Committee believes that the Commission should bear the burden of proving by clear and convincing evidence that the penal sanction it proposes to impose in barring individuals from the securities industry is necessary in the "public interest". The Commission's power to impose sanctions is not unlimited. A sanction is authorized only upon a finding that it is necessary in the public interest. 15 USC §80a-9(b). This case presents a clear example of how the "public interest" standard in Commission administrative proceedings somehow gets tossed on the ash heap. The Committee believes that this case demonstrates the gross inappropriateness of the sanctions that are often imposed by the Commission. (E.g., *Investors Research Corp. v. SEC,* No. 78-1597 (D.C. Cir., April 29, 1980) (where censure was the sanction for actual, not potential, diversion of fund assets to pay for computer services for the adviser.)

There has been no finding in this case that anyone has been hurt by the alleged violations. The mutual funds have not been hurt – they benefitted from the custodianship transfers and the expense overruns were repaid at commercial interest rates.

No one has gained from the alleged violations. Steadman's loans from the Chase Manhattan Bank were made at normal interest rates, neither Steadman nor SSC were accorded favorable treatment by the banks, the loans were obtained on the basis of Steadman's ability to repay and they were adequately collateralized. In short, the loans were normal, everyday business arrangements that Steadman simply considered a private matter, which along with many other private details, are not normally made public or discussed with business associates. The loans were irrelevant to Steadman's relationship to the mutual funds.

Given all of these facts, the Committee finds it difficult to rationalize how the Commission could possibly justify the destruction of debarment as being necessary in the public interest. The Committee believes that this is an instance wherein the Court should set aside the penalty imposed.[15]

This case has been going on for nearly a decade during which Steadman has lived under a cloud which has interferred seriously with all his business operations and he has incurred legal expenses approaching one-half million dollars. The Committee respectfully submits that this is an appropriate instance for the Court to dispose of the matter now by dismissing the case or remanding it to the Fifth

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[15] 5 USC §§551(10), 551(3), 702 and 706 authorize such review. Moreover, the courts have traditionally undertaken to review and limit SEC sanctions. E.g., *Arthur Lipper Corp. v. SEC*, 547 F2d 171 (2d Cir.1976); *Beck v. SEC*, 430 F2d 673 (6th Cir.1970); *Quinn & Co. v. SEC*, 452 F2d 943 (10th Cir.1971), *cert.den.*, 406 U.S. 957 (1972).

Circuit to take appropriate steps to dismiss the proceeding. It seems plain that Steadman has suffered enough. Here the administrative process has been punishment enough.

The judgment below should be reversed.

Respectfully submitted,

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